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The American economy has experienced exceptionally high levels of consumption and low levels of net saving and net investment over the last six years as compared with earlier history. Without major economic policy changes, domestic imbalances and the international deficit will almost certainly continue and court a clear and increasing risk to financial and economic stability over time. Even if economic shocks can be avoided, these imbalances will undermine our future productivity and living standards.

Federal Reserve Bank of New York
74th Annual Report
December 1988, p.7

HIGHLIGHTS

Based on the arguments of much improved corporate earnings and reduced valuations many now claim that the U.S. stock market has the potential to go a great deal higher (even 5000 on the Dow). These two presumptions are deadly false.

We can only say that the favourite story of higher corporate earnings is a spectacular yarn. Not only is the order of magnitude wrong, but unbelievably, so is the direction in trend.

What we see is a profitless prosperity. The whole spectre of a profit-boom turns out to be sheer illusory nonsense when the extraordinary profits arising from the accounting shenanigans involving inventories and depreciation are eliminated.

On the whole, share valuations are thought to be compelling for higher stock markets. We see a myriad of snags and flaws in this argument. For example, in the case of lower price/earnings multiples one could frame the perspective as follows: a P/E multiple of 12 times earnings today is equivalent to a P/E of 25 in the 1960s.

And as we have often stated in the case of North America, excessive consumption crowds out investment and through the aegis of floating currencies hollows out its supply-side structure. Depressed industrial asset values are a symptom of that deficiency, not the grounds for a maniacal bull market.

People are starting to think that the high-deficit economies can live with high interest rates indefinitely. We believe that this resistance to high interest rates will prove to be just temporary. The whole phenomenon centres around the effects of capital inflows.

Large capital inflows tend to have expansive effects on deficit economies, prolonging their recovery. Paradoxically, capital imports tend to fuel a consumption boom while capital exports tend to stimulate export and investment (the latter through the aegis of a depreciating currency).

The performances of two of the world's major economies - West Germany and the United States - make an interesting study in antithesis. Will a booming economy trigger interest rate pressures in Germany?

We must sound an alarm on Canada. It's only a matter of time until either one of two events will force a sharp drop in the Canadian dollar. Such an event is bound to trigger an outflow of "hot money" capital and higher rates.

DISPELLING THE SPELL-BOUNDING MISINFORMATION OF WALL STREET

As stock markets post new highs worldwide, North American brokerage firms are launching a soothing investor relations campaign ...one that deals with investor's apprehension of the two-year anniversary of the stock market crash and stock price levels that are finally as high again as the ignominious peaks of August 1987.

As Fall Fells Flowers... Doing their best to exorcise any goblins of 1987 that might still haunt investors, market pundits are imaginatively explaining "why this time is different". On the offensive, many claim that the U.S. stock market has the potential to go a great deal higher (even 5000 on the Dow) before it matches the overvalued extremes of October 1987. Some, are even forecasting a long-term financial mania.

The common argument of all pro-bullish opinions is that U.S. business profits are sharply higher than two years ago. As such, much comfort is found in the fact that price-earnings ratios are fairly low by the standards of the 1980s and 1960s. In fact, most valuations are seen as broadly supportive to higher stock markets. However, we see a myriad of snags and fallacies to these sweeping and superficial conclusions.

DISPELLING THE NEW SLOGAN: "P/E's ARE CHEAP"

U.S. shares are presently selling at a bargain of 12 times earnings instead of the 22 times that was the case in August 1987. On the surface, it seems that corporate earnings in the United States have skyrocketed since 1987. Earnings per share on the S & P 500 have risen from $14.42 during the second quarter of 1987 to $25 during this year's first quarter. It's been this ostensibly steep rise in earnings that has caused the lower price-earnings ratio to play such a prominent role in bullish arguments. But things are not as they seem.

Basic Fallacies and Oversights. We see several misconceptions, however, that effectively obliterate the consensus opinion that price/earnings multiples, dividend yields and market-to-replacement-values are a strong support to stock markets. In the first instance, earnings figures are too good to be true and in fact are shockingly disappointing as we'll document.

Secondly, as far as valuations measures are concerned, P/E's have very low predictive value in determining future stock market performance in any case. In fact, P/E's even rank low in reliably measuring current values. There are many instances, where a low multiple on peak cyclical earnings can be much more hazardous than stratospheric P/E's on depressed business-trough earnings.

Thirdly, nowhere in the discussion of earnings does anyone make any mention of future earnings growth as opposed to past earnings growth. Presumably, expectations of high future earnings growth should properly contribute to higher P/E multiples on present earnings, and the inverse should apply in the opposite set of circumstances.

FOCUSING ON THE EARNINGS SIDE OF THE P/E EQUATION.

The most important point of focus, however, is the real performance of corporate earnings since it is earnings that are at the root of most valuations measurements in one form or another. Low P/E's say nothing about the actual profitability of U.S. businesses and, in fact, can be very misleading. And, at the moment, earnings are utterly deceptive.

But how then is it possible that widely-publicized earnings figures can be grossly distorted? There are at least two related reasons. It all starts with "profits" that are reported by the corporations themselves (a product of financial reporting for the benefit of capital markets). But, accepting reported earnings for face value can be a fatal mistake since financial definitions of earnings can be very different from economic or "real" earnings.

Inventory Profits Make a High Contribution. Since 1986, "reported" company earnings have been grossly inflated by accounting adjustments that relate to inventories and depreciation. Inventory profits have been large recently since producer price inflation has risen from 3% to 9% between the first quarters of 1988 and 1989. First-in-first-out (FIFO) inventory accounting captures rising inventory prices as earnings. That means that profits are inflated by deferring the cost of capital on inventories since companies will have to replace these inventories at higher market prices in the course of future production.

As a matter of interest, German corporations use the same valuation method, but contrary to the U.S., they establish a tax-deductible legal price increase reserve for the replacement costs. As such, changing price levels do not impact earnings levels.

...And So Have Depreciation Provisions. The second factor that has artificially boosted U.S. business profits, has been the phasing out of accelerated depreciation provisions that were introduced in 1981. The 1986 Tax Reform Act wiped out much of these earlier tax deferring benefits that resulted from allowing companies to depreciate their equipment faster than the actual loss in value through wear and tear. During these years profits were understated, thereby reducing tax bills.

The curtailment of liberal depreciation practices now produces sharply higher reported profits. A larger chunk of corporate cash flow is being reported as taxed profits and not as untaxed depreciation.

Effect of Earnings Gimmickry Shouldn't Be Underestimated. What have these accounting gimmicks to do with Wall Street's bullishness? In short, everything. If we were not so surprised ourselves, we would ask our readers to guess how great the impact of these two effects have been on reported U.S. business profits. The figures strain credulity.

CORPORATE EARNINGS DEFROCKED. IT'S REALLY A DECLINE.

Returning to Wall Street's favourite story, that a spectacular earnings boom is at the root of the sharp decline in price-earnings ratios thus making stock markets compelling values, we can only say that this argument is a spectacular yarn. *Not only is the order of magnitude wrong, but unbelievably, so is the direction of the earnings trends.*

If inflationary profits from inventories and the accounting changes stemming from the different tax treatment of depreciation were to be excluded, the greatly heralded profit boom turns into a whimper of a profit decline...*yes, a profit decline*!

Genuine corporate profits, that is profits from current production - adjusted for windfall gains - have been flat for several years. What's more, compared to their level in the third quarter of 1987 - preceding the October 1987 crash - pre-tax earnings are actually down from $322 billion to $309.1 billion.

Other Extra-Ordinary Factors. It would be worse still, if U.S. corporations had not been bolstered by sharply rising profits from overseas operations. That kick-start was a function of both booming European economies and a slumping U.S. dollar. Isolating that income source, it is correct to say that purely domestic pre-tax profits from current production have declined from $286.7 billion in the third quarter of 1987 to $260.7 billion in the second quarter of 1989 - a 10% fall! (Please see the insert on the next page for further earnings explanations.)

A HISTORICAL PERSPECTIVE ON CORPORATE EARNINGS

The weak trend in real profits of U.S. businesses is laid completely naked when viewed from a longer-term perspective. Obviously, it's to be expected that profits rise - at least in nominal terms - over the course of an economic upswing. But what's more important is the relationship of profits to the overall income of the economy. How good are U.S. corporate earnings in the

A CLOSER LOOK AT U.S EARNINGS TRENDS

U.S. Growth and Distribution of Income

($U.S. BILLIONS)	Wages & Salaries	Personal Interest Income	Transfer Payments	Profits Before Tax/After
1980	1,372	272	325	237 / 152
1988	2,429	662	629	307 / 169
% Growth	77%	143.4	93.5	29.5 / 11.2

No doubt, there is an overriding perception that this long economic upswing in the United States has generated high business profits, particularly in view of the famous, massive supply-side tax cuts. Quite the contrary is true. Comparing the growth of various income components (both before and after taxes) it's obvious that business profits have been the outstanding laggard.

All that this long business upswing has brought is a drastic income redistribution, but not in the direction that everyone would expect from supply-side economics - that is not toward business profits. Both, business and wage earners, were the big losers, while interest income was the big gainer.

Given the fact that national income can only be distributed once, this shift is hardly astonishing. It's the logical outcome of an economic upswing that has been debt-driven in the extreme, and with relatively high-level real interest rates.

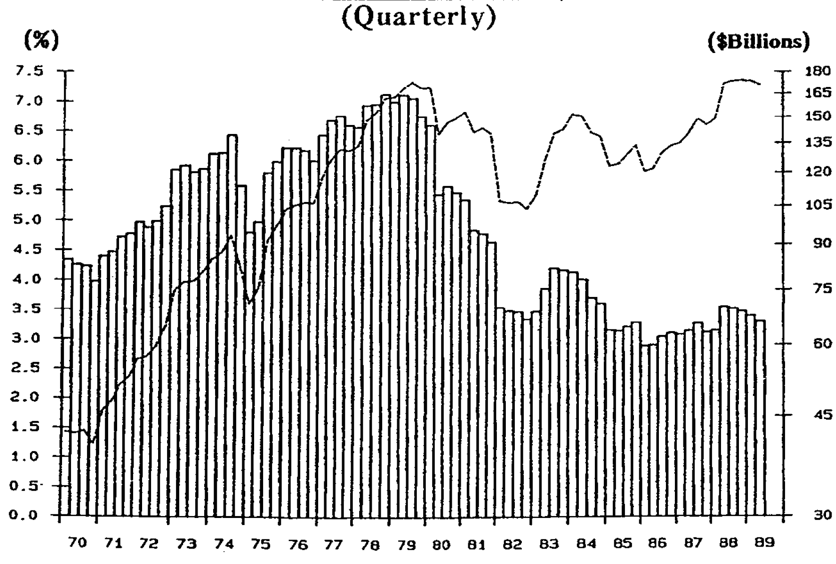
Just think of it. Between 1981 to 1988, the Reagan Administration has altogether pumped $5,739 billion of credit-money into the economy. That compares with a simultaneous increase in nominal GNP of only $1.830 billion. This means that every $1 of additional GNP required more than $3 additional debt. While nearly all the money that went into GNP have been consumed, the debt - which has increasingly become the asset of foreigners - cumulates with the addition of interest costs.

1980s compared with those of the 1970s? Corporate profits as a percentage of GNP, as shown in the graph on this page, reveals a damning reality.

When we first posed this chart we had an inkling that the present profit picture - especially when viewed from a historical perspective - was much worse than what most investors assume. All-the-same, we didn't quite trust our eyes when this chart first emerged.

The first thought that comes to mind, is a *profitless prosperity*. In actual fact, the whole spectre of a profit-boom and a corresponding steep fall in price earnings ratios turns out to be complete illusory nonsense. Not only did earnings lag GNP, but earnings have actually declined (after adjustment for the

U.S. BUSINESS PROFITS / GNP
(Quarterly)



Source: SMH-Research

extraordinary profits arising from the accounting shenanigans involving inventories and depreciation).

OTHER VALUATION FALLACIES: DIVIDEND YIELDS

Another valuation measure used to support a continuing bull market in the U.S. is the argument that dividend yields are now higher. At the August 1987 highs, the yield on the Dow Industrial had diminished to a minuscule 2.61% compared to then yielding long Treasury bonds of 8.94% (which were then heading higher). Today, by contrast, it is held that the Dow yield is a much more attractive 3.5%, while the Treasury yield has declined to 8.2%.

Doesn't the overall investment backdrop look better than that in 1987? It looks somewhat better, yes, but that means some underlying comparisons would have to be overlooked. In the first place, one shouldn't forget that we are making comparisons to the period just before the crash, a time when equity valuations were amongst the most extreme of the entire century. And whether corporate dividend payments are high or not, it is still true that yield differentials between dividend yields and bonds - ranging from around 8% for Treasury bonds to junk bonds yielding 13-17% - still remain a powerful incentive for investors to shift their investments towards bonds.

What Drives Corporate Dividend Policy. Our main objection against using dividend yields as a measure of stock valuation goes much deeper. For to look at dividend yields in isolation, one would have to first establish that dividend payments move in line with earnings, being as much a reflection of past corporate performance as a signal about future earnings sustainability.

That tenet of dividend policy no longer proves true in the United States, Britain and some other countries. Why? For many corporations, dividends have become part of the leverage game. Raising dividends - regardless of profitability - is a widespread practice for a number of reasons. In fact, the declared aim of high dividend payments is "shark repellant" by boosting share prices against corporate raiders.

Here are a few figures that affirm our point. Between 1980 and 1988, U.S. corporations more than doubled their dividend payments from $54 billion to $110 billion while retained earnings were slashed from $97.6 billion to $58.5 billion. From that perspective, the argument that stock prices are indeed supported by higher dividends begin to look pretty silly.

A THIRD VALUATION FALLACY: MARKET-TO-REPLACEMENT BOOK VALUE RATIO

As proof that U.S. stocks offer attractive value, much has been made of the fact that stocks are now selling at about a 25% discount to the current replacement cost of assets (or the replacement book value). During the 1960s, market valuation had moved to premium of 10-15% followed by a period of extreme undervaluation in the 1970s, when discounts to replacement value ranged as high as 50-60%.

According to this measure of valuation, it's argued that U.S. stocks are now selling roughly midway between the minimum discount of the 1970s and the maximum premium of the 1960s. On this plane of reasoning then, birth is given to the idea that the U.S. bull market has quite a way to go yet before it reaches over-valued territory.

By implication, if one agrees with that point of view, one would neglect two very important aspects: firstly, what is the causative factor that contributes to depressed asset values in the first place: and secondarily, that the 1970s, which was marked by double-digit inflation rates and extremely tight money, is a non-recurring exception.

To many people it may seem normal that the price level of existing plant should at least be equal to the replacement cost or the cost of corresponding new investment. If purchasing

existing assets is so much cheaper than building new ones, doesn't that depress new investment?

Obviously, this value gap that persists between the market valuation and production costs of new plant within corporate America, is both the central cause and central motive of the merger and acquisition mania. And it's surely not accidental that this coincides with record low net investment.

Corporate Philosophy a Symptom of Much Greater Malady. But aren't then the corporate raiders perfectly right when they complain that it is bad management that causes the undervaluation of most stocks, when they set themselves the task of uncovering hidden treasures? While the raiders have made pots of money by putting their beliefs to action, their concept is nevertheless grossly fallacious from a macroeconomic point of view.

There are perfectly good and compelling economic reasons why U.S. stocks - and the stocks of many other countries - are selling at a heavy discount against current replacement value. What about the inane economics that fosters this situation? The nonsense begins with the general reproach of raiders that sharply undervalued share prices reflect bad management. We find it hard to believe that there is virtually no one who disputes this view.

Let us state one thing that used to be a common understanding of economists. Market values or demand prices of real assets depend principally on their inherent earnings flows. But that's only half of this time-tested rationale. The second and crucial question always centres on the interest rate at which prospective earnings are capitalized. The point to see is that this decisive capitalization factor lies entirely outside the purview of corporations.

The all-important determinant of this key capitalization factor is the long-term interest rate. A low rate of long-term interest rates (or low bond yields) will assuredly mean high market prices for existing productive assets. Similarly, the converse holds true. It follows then that the market valuation can change for either reason - because business earnings have changed or because the capitalization factor (the long-term interest rate) has changed.

Cutting this theoretical diversion short, here is the key point: the essential ingredient for the high valuations of corporate assets on stock exchanges during the 1960s was an abundance of domestic savings reflected in a long-term bond yield barely topping 4%. Accordingly, corporations could normally be valued at 25 times earnings. Now compare this with today's diametrically opposite capital supply and capital market conditions expressed in bond yields of 8% and higher. Any decrease in available savings or increase in the long-term interest rate is bound to lower the price of fixed capital, and hence the level of new investment.

On that basis, comparing today's relationship of U.S. stock prices and their underlying replacement value with that of the 1960s misses the entire root cause of what determines asset values in the first place. On the proof of that comparison it is simply insane to say that stocks have considerable room for further gains, especially in view of the fact that relevant bond yields have more than doubled.

One could frame the perspective more correctly as follows: a P/E multiple of 12 times earnings today is equivalent to a P/E of 25 in the 1960s!

Evidence of Capital Consumption? In this regard it is interesting to note what Frederick Von Hayek had to say about market values versus replacement costs in his paper on "Capital Consumption". Hayek explains:

> *"There is one symptom which provides a fairly useful clue to the development of the capital of the economy as a whole: the evaluation of existing industrial capital on the share exchange."*

According to his thesis, depressed values of industrial assets find their root cause in excessive consumption. As we have so often postulated in the case of North America, excessive consumption crowds out and discourages investment, and furthermore through the aegis of a floating currency eventually translates into a hollowing out of the country's industrial (or supply-side) structure.

INVESTMENT SENTIMENT COMPARED

Apart from the valuation fallacies we have discussed, another important factor to consider is the difference in sentiment between the summers of 1987 and 1989. At that earlier time, there was certainly very little euphoria about the U.S. economy or the dollar. As it happened, the economies of the United States and others worldwide proved much stronger than had been anticipated. In the case of the dollar, persistent and massive interventions by the central banks were required to prevent a debilitating collapse. If there was any excessive optimism in 1987, it was limited to the U.S. stock market, but nothing else.

In our view, general sentiment today is far more euphoric than in 1987. Firstly, there is now euphoria over the U.S. dollar. That's a key difference since a strong dollar plays a crucial role in attracting foreign capital which in turn helps boost stocks and bonds prices. Second, there are high hopes for a "soft landing" of the U.S. economy. In a more general sense, there is overwhelming confidence in the basic strength of the U.S. economy and in the power of the U.S. government and the Federal Reserve to fine tune the economy down a satisfactory growth path with low inflation. This conviction has been strongly reinforced given the rapid recovery of the U.S. economy and the U.S. stock market after the crash.

Lastly, of course, there is strong optimism for both bonds and stocks. It is now a strong consensus, that stocks are still within a secular bull trend, and that any short-term weakness (which some do worry about) should be used as a buying opportunity. On balance, it must be said that optimism and euphoria is now much more pervasive than in 1987.

RELATIVE POSITION OF GLOBAL ECONOMIES ALSO DIFFERENT

But let's return to facts - one thing is true: In many, if not most countries, economic and financial conditions are strikingly different today than in 1987. In this respect there are now greater variances between countries. In some countries - United States, Britain, Canada, Australia and some others - conditions have sharply deteriorated. The economies there are turning sluggish with high inflation rates, falling business profits and high external deficits.

However, on the other side, there is no doubting the strength of the economies in continental Europe, with Germany as the chief locomotive. Investment spending is strong in all of Europe. Inter-European trade is buoyant and significant tax cuts are due in Germany next January. No slowdown seems to be apparent.

On the overall, however, it is true that world economic growth is now decelerating rather than on the verge of an acceleration as was the case in 1987.

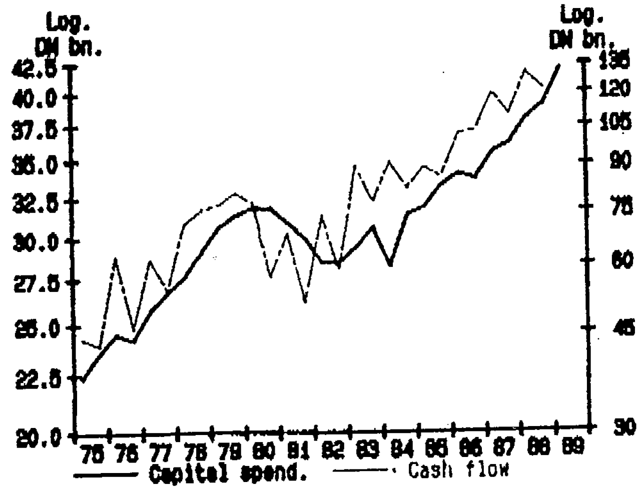
GERMANY: HARDLY A CLOUD IN THE SKY

The differences in Germany and the U.S. are becoming a fascinating study in fundamental economics. While, U.S. analysts and economists give little or no attention to the actual shifts in the composition of demand and production it is in these respects, as a matter of fact, that the German and American economies have differed in such a striking way.

Corporate Sector Healthy Savers. The following chart goes to the heart of the comparison and points out an all-important difference: the development of business investment and cash flow. What you see is surging corporate cash low. High levels of investment are being almost fully

funded internally as booming profits are reinvested. In the U.S., corporations are heavily leveraging their financial structures and dissaving. German companies are heavily de-leveraging and saving.

BUSINESS INVESTMENT AND CASH FLOW
WEST GERMANY



Source: SMH-Research

Fastest Growing Major Economy This Year. Thanks to strong exports and investment activity, real GNP in the second quarter was up 4.9% over a year ago and by 4.6% for the first half of 1989. Goods and services exports were up 15% in the second quarter. The main source of this superlative growth - more than 3% percentage points - is attributable to productivity growth. Employment, too, for the first time, is also contributing to economic growth.

We have been highly optimistic on the German economy for quite some time in contrast to our sharp pessimism on North American and other externally imbalanced economies. It wasn't always that way. There was a time - when quite correctly - in the early 1970s we scolded Germany.

Even the sharply rising immigration of East Germans and other ethnic Germans from neighbouring communist countries makes us optimistic. Within the next four years, the total influx may easily top 2 million or about 5% of the present West German population. The new Germans will add disproportionately to demand, buying homes, furniture and clothing. Their settling should be expected to boost the house-building sector and add sharply to rising durables purchases. On the other hand, since most immigrants are young, the labour force will grow just as sharply. This could be expected to transform West Germany from an aging economy, limited to an underlying growth rate of less than 3%, to one capable of a livelier rate of almost 4%..

The Question of Restrictive Monetary Policy. Many might now worry about the prospect of a restrictive monetary policy, given the booming economy and the weak D-Mark. As it is, every meeting of the Bundesbank Counsel is preceded by anxious rumours of an imminent hike in the Lombard rate.

We don't think any such move is likely at least over the next two or three months. What happens next year - when the third stage of Germany's tax reform program kicks in - would be dicey to predict, however. A tax reduction of over DM 24 billion (more than 1% of GNP) is due then.

In our view (and the Bundesbank for that matter) everything depends on the U.S. dollar. There is no question that the bank is extremely frustrated about the D-Mark's weakness. There is nothing it wants more that a strong currency, but not to the point of raising interest rates for that particular purpose. Other countries might then just follow suit.

....Inflation Looks Benign. For the time being, everything looks trouble-free on the inflation front. In the first place, wage raises are still moderate, and importantly, strong productivity advancements are holding labour unit costs absolutely flat. And since commodity prices are weakening, there is little cost pressure. As profits boom, business is maintaining pricing discipline. Besides, so far, relatively weak consumer demand is keeping general prices in check.

Last but not least, the fixed income markets have already done the job for the Bundesbank. The 3-month Euro-Deutschmark rate has risen from 6.88% at the end of July to 7.45%. In like fashion, 10-year Bunds have increased yields from 6.5% to 7%. Relative to present U.S. yields of 8.2%, these rates must be considered very attractive.

A TIMELY LOOK AT CANADA

For those already familiar with the recent economic travails of Australia and Britain, we must sound the alarms on Canada - a country where developments seem to be fast approaching a "blow-out". Despite possessing one of the most resolute central bankers in the western world, Mr. John Crow, the country faces a virtually unmanageable set of economic forces that surely seem destined to force an unwanted hard landing. All the hallmarks of excess consumption and insufficient savings are coming to the fore.

In spite of a sharply inverted yield curve (short-term rates exceed 12.25%), consumption expenditure remain strong. Recent GDP results for the second quarter still reveal personal expenditures growing at a real rate of 4.6%. Not surprisingly, the current account deficit has gaped to a rate of $21.7 billion per annum (representing 3.7% of GNP) despite a significant although shrinking merchandise trade surplus. That size of a current account deficit in relation to GNP is only exceeded by a few others such as Australia and Britain.

Pressure Points That Might Burst. But here are some critical differences that international investors should keep in mind. While the currencies of the latter two countries already reflect some apprehension on the part of investors, Canada's dollar is still near decade-highs of $0.85 against the U.S. dollar, being levitated on the highest interest rate differential against U.S. short rates in memory. The current spread between the short-term rates of those two countries now exceeds 460 basis points; even greater than prevailed during the February 1986 currency crisis that sent the Canadian dollar below $0.70 U.S. (See the following Exhibits 2 and 3).

Exhibit 2

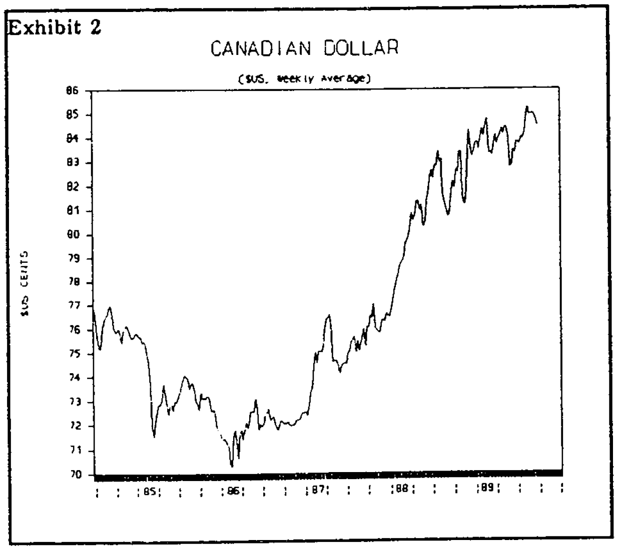
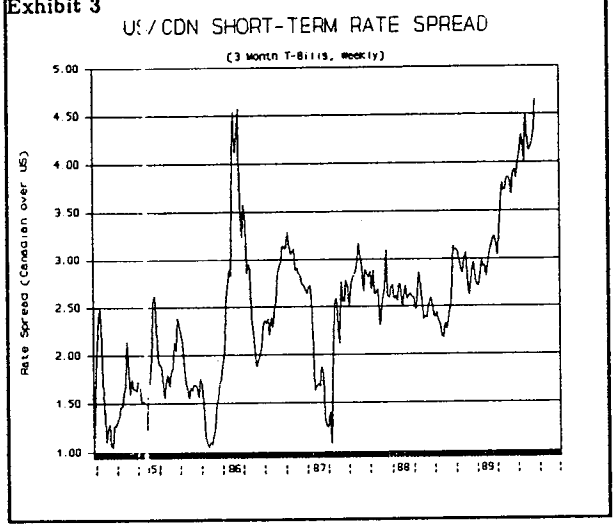
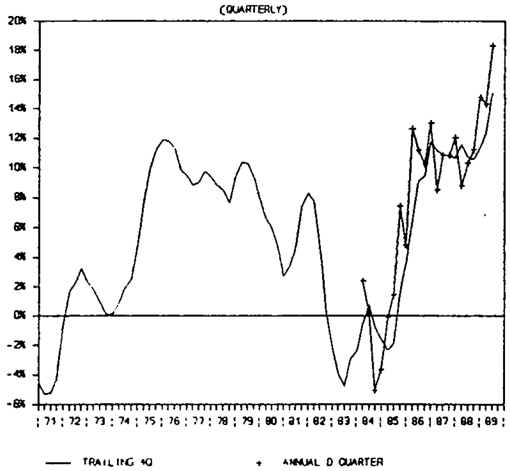


Exhibit 3



In the meantime, foreign capital is being sucked in at a record rate. Foreign capital savings now represent over 18% of available domestic savings, the largest on modern record (Exhibit 4). Domestically originated savings have fallen sharply this decade and have been insufficient to maintain capital stocks. Consequently, reliance on foreign capital has become acute. Ever since Canada has pursued a policy of high interest rate differentials (1986), well over $70 billion in foreign capital has accumulated in marketable income securities alone. The fact that a middle-tier economy sports the third largest T-bill market in the world is testament to the favours of foreigners.

Exhibit 4
FOREIGN SAVINGS/GROSS NATIONAL SAVINGS



Economy Now Decelerating. In the meantime, Canada's economy has begun to decelerate, only growing at rate of 0.8% in the second quarter versus 3.7% during the first and an average rate of 5.0% in 1988. Capital expenditures now face slowing momentum, and despite the stupendous inflows of foreign capital, never did experience a expansion phase as heady as that of the late 1970s.

It only seems a matter of time until either one of two events will force a sharp drop in the Canadian dollar which in turn is bound to trigger an outflow of "hot money" capital and prompt much higher long-term rates. Either a rapidly slowing economy will force an attempt at a looser monetary policy, thus collapsing the high interest rate differentials that support the Canadian dollar or a worsening current account deficit or similar imbalance will shake the confidence of foreign investors. Whichever event transpires, the quixotic flows of foreign hot-money is sure to play a dominating and explosive role.

A TURNING POINT FOR THE HIGH-INTEREST RATE COUNTRIES?

While the European and Japanese economies merrily bowl along (although Japan has settled down to a milder pace of 4% growth), the big question is whether the "high-interest rate" countries will face either a soft or hard landings. The Anglo-Saxon quarter alone (Australia, New Zealand, United States, Canada and Britain) have been pulling in over $200 billion per annum to finance their current account deficits.

Considering this stark imbalance and the high rates of these countries (with the exception of the United States where rates now appear on the low side) the resilience of their respective economies has been surprising. People are starting to think that these economies can live with these high interest rates indefinitely. Apart from Britain recently, this entire group is distinguished by high job growth. Strangely, many regard job growth as the clearest manifestation of outstanding economic dynamism.

We believe this resistance to high interest rates is just temporary. A lengthy period of low or no growth - stagflation in other words - is in store for these economies. Nevertheless, we have been keen to further investigate the reasons for the lagged response to interest rates. The salient question really has to do with how large capital inflows impact the receiving economy.

The Effects of Large Capital Inflows. The prevailing view is that large current-account deficits act as a major drag on economic growth, which in turn is compounded by high exchange and interest rates. That is certainly correct. But what offsets this drag is the easy access to foreign credit. With no limit on foreign borrowing, credit can only be made expensive, but not scarce. As long as there are willing domestic borrowers and lenders, the music will go on much longer than in the past when a monetary tightening rapidly ended in a liquidity crunch. Actually, we have to realize that these capital inflows can tend to keep interest rates lower - especially long-term rates - than they might otherwise be.

Capital inflows tend to have expansive effects on these economies, prolonging their recovery. But the important point to see is that the mix of high interest rates, high exchange rates and large capital inflows, impacts specific sectors of these domestic economies in different ways. The most notable difference in this respect is between the manufacturing and service sectors.

Only Short-term Effects are Lauded. The service sector - where all the employment gains take place - are not sensitive to either high exchange or interest rates. The brunt of this policy mix is therefore borne by the manufacturing sector. High interest rates and an overvalued currency hits investment and exports. Therefore, weakness emanating from the manufacturing sector, then eventually slows the broader economy. That is a very gradual process in contrast to the quick shock therapy of a credit crunch.

While most financial observers tend to praise the benign effects of large capital inflows, they are blind to the malignant ones. The main "beneficial" effect, that price inflation is moderated, is widely recognized. But the deep devastation running its course over the longer-run adversely affecting the allocation of resources and the whole productive economy is conveniently ignored.

Paradoxically then, capital imports tend to fuel a consumption boom while capital exports tend to stimulate exports and investment (through the aegis of a depreciating currency in the latter instance).

SUMMARY CONCLUSIONS

The conclusion seems inescapable. The resilience of the high-yield countries can only prove to be only temporary. The longer-term malignancies will increasingly become short-term thorns. In fact, already, signs of a more rapid weakening abound.

The realization that interest rates would need to stay up longer is the major reason that the high-yielding currencies have remained strong so long. It is true that these countries have little scope to counter any economic slowdown either in terms of fiscal or monetary policy. But surely, that's no reason for the bullishness that prevails for these currencies. It will only mean deeper weakness later.

In the meantime, it is this positive behaviour of high-yielding currencies that fosters the willingness to continue capital exports and draws ample foreign capital into these economies.

The critical phase for all these economies will begin when their economies finally weaken sharply and the policy dilemma between domestic and external requirements becomes obvious. Then, as optimism and confidence vaporizes, capital inflows will dry up suddenly, causing a steep rise in long-term interest rates.

That is not a theoretical scenario. To a degree, it already happened twice in the United States in 1987. During the spring, a slowing of capital inflows pushed long-term rates up and the dollar down. In the fall, a repeat performance ensued again driving up rates but this time by over 3 percentage points to over 10%. That last event played a significant role in triggering Black Monday.

In assessing the health and strength of an economy and its respective financial markets, one must focus on the following factors: (1) production and productivity growth, (2) business profits and cash flow, and (3) business investment and national savings. America (in fact all of North America) ranks dismally on all of these.

From that perspective, to be quite frank, we are at a complete loss to understand the general bullishness in the U.S. What is so positive compared to 1987? As we've shown, just a gentle weakening in economic growth has already been enough to slash business profits and cash flow as flattening productivity growth sent unit labour costs soaring.

The U.S stock market is definitely not cradled in any strong fundamental value. Rather, based on the scarcity of domestic earnings, U.S. stocks appear grossly overpriced. Investors should beware of the simplistic undervaluation arguments.

What is driving U.S stock prices has absolutely nothing to do with the normal investment activity of personal and institutional investors. Rather it is a pervasive diversion of credit to Wall Street through the corporate merger and acquisition mania, and foreign investors. Clearly, values are being boosted at the expense of new productive investment and in a manner in which volatility can strike financial markets at any time.

Yet, quite a few fanciful forecasters are dreaming of a repeat of 1985/87 when a weakening economy and declining inflation were greeted with plummeting bond yields, soaring stock prices, and the profitable slogan of "disinflation".

To these notions all we can say is, forget it. It is pure nonsense. It reminds of an ironic remark once made by Keynes. He quipped: "*men are always too easily conditioned*" and always "*expect that, when the bell rings, they will have the same experience as last time*".

True, just as in 1985/86, the economy is weakening. But the truly critical difference between then and now lies within monetary policy - more precisely in the pace of credit expansion. In 1984/86, the Fed opened its money and credit spigots as never before, leading to a blistering pace in credit growth of more than 14% (nominal).

Then it was possible that a drastic credit stimulation, combined with a massive dollar devaluation, could succeed in preventing a recession. In the interim, though, its chief and most spectacular effect has been on asset prices, rocketing up both stocks and bond prices, and worsening a myriad of imbalances and excesses.

If we can be sure of one thing today, it is that there will be no repeat of such a rampant credit expansion. Credit growth is now already around 8%. While we expect a more aggressive easing by the Fed as the economy becomes increasingly sluggish, the vulnerability of the dollar will set the limits to these efforts and may, in fact, backfire.

In conclusion, the key difference between now and 1987 is the U.S. dollar. Earlier in 1987, since the dollar was weak, a modest increase in short-rates coincided with steep rises in long-term rates. This year, with a strong dollar, lower long-term rates were possible as short rates climbed.

To us, timing is the only question. Judging from the emerging weakness in many of the deficit countries we would think that the fourth quarter of this year - at the latest the first quarter in 1990 - will witness the watershed in currency markets.

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